

TREATMENT OF PREPAID DERIVATIVE CONTRACTS

Background

Traditional forward contracts

A forward contract is an agreement to deliver a specified quantity of a defined item or class of property, such as corn, crude oil, foreign currency, or corporate stock, at a specified future date and at an agreed price. A forward contract may call for settlement of the contract by delivery of the property to which the contract relates, or it may permit settlement by cash payment equal to the difference between the contract price and the then-current (or “spot”) price at the time the contract expires. In a typical forward contract, neither party to the contract makes a payment at the time the contract is executed, although arrangements for collateral may be made.

A futures contract is a standardized form of forward contract entered into through the medium of an organized futures exchange. The exchange acts as the counterparty to every transaction. As a result, every trade on the futures exchange effectively results in two contracts: one between the forward buyer and the exchange, and the other between the forward seller and the exchange. The parties to a futures contract post “variation margin”; this amount is adjusted daily to reflect the extent to which the position of a futures contract buyer or seller is “in the money” (i.e., reflects an unrealized profit) or “out of the money” (i.e., reflects an unrealized loss).

Under standard arbitrage theory, the price under a traditional forward or futures contract for a nonperishable commodity (gold, for example), or a traded financial instrument equals the item’s current (“spot”) price at the time the contract is executed, plus the “cost to carry” the item for the term of the contract (a time value of money return on the cash that would be invested in acquiring the item at execution of the contract and holding it until the final delivery date, together with any warehousing or similar expenses) and minus the expected cash yield on the item (for example, expected dividends if the item is corporate stock) over the term of the contract. For example, if one share of stock in Company XYZ costs \$100 today, the one-year interest rate is six percent, and XYZ is expected to pay \$4 per share in dividends over the coming year, the one-year forward price of one share of XYZ stock would be \$102 (\$100 plus 6 percent interest minus \$4 yield). If XYZ stock paid no dividend (or instead XYZ stock was a precious metal or foreign currency), the forward price would be \$106, reflecting simply the time value of money.¹

In each case, the forward price reflects simply the current spot price, plus the “cost to carry,” minus projected cash returns over the contract term, *not* market sentiments about where prices are headed in the future. Forward prices thus are driven primarily by current prices and interest rates, and do not serve as predictions of the future. If, for example, forward prices were higher than that predicted by this model, then arbitrageurs could earn riskless profits by selling

¹ These examples ignore storage costs and minor timing differences in the cash flows.

the property forward, actually buying the property today, and actually financing the net cost of owning the property until the contract matured. If forward prices were lower, arbitrageurs would sell the property short today, invest the cash proceeds at current interest rates, and buy the property forward to deliver to close out the short sale.

Prepaid forward contracts

Some forward contracts call for the forward buyer to pay the contract price to the forward seller when the contract is executed, rather than at maturity. These contracts are referred to as “prepaid forward contracts.”

By contrast with the pricing of a traditional forward contract in which no payment is made when the contract is executed, the pricing of a true prepaid forward contract (in which the seller is free to use the forward sales proceeds that it receives at execution of the contract as it wishes, without compensation to the buyer) reflects only the spot price of the item to which the contract relates plus any warehousing or similar expenses. The long party in a prepaid forward contract obtains the economic return on the item underlying the contract but also pays for the item at the outset. If the underlying property has a current cash yield, then the seller in a true prepaid forward contract would in some fashion pass that yield (or an estimate thereof) to the buyer. Similarly, the pricing of a true prepaid forward contract in respect of property without a cash yield would be largely indistinguishable from that of a current cash sale.

Some prepaid forward contracts are better understood as traditional forward contracts in respect of which the forward buyer has posted 100 percent of the purchase price as collateral, on which the forward seller in turn is required to pay interest. The forward contract is priced like any other traditional forward contract, but the time value of money return paid to the buyer on the cash it paid on execution compensates the buyer for the time value of money accretion in the forward price of the property.

A prepaid forward contract thus might be priced like a current sale, or alternatively might be priced like a traditional forward contract, but in respect of which the forward buyer is paid or otherwise credited with a time value of money return. Arbitrage theory suggests that the two formulations are equivalent in value.

Exchange traded notes

Several financial institutions have issued long-term financial instruments colloquially referred to as exchange traded notes (“ETNs”). Existing ETNs generally are intended to provide investors the returns of specified market indices (less fees owed to the issuing bank). Examples of returns tracked by these indices include changes in the values of physical commodities; currency exchange rate movements; and the performance of developing market equities or other groups of equities. ETNs often have long maturity dates (for example, 30 years), but afford investors an opportunity to “cash out” earlier through optional redemptions.

Some ETNs track the performance of a notional position in futures contracts that are periodically “rolled” before their maturity date into new futures contracts. At the same time, the purchaser’s cash investment is credited with a notional specified time value of money return. Consistent with the prior discussion, the economic position of the investor in such an ETN can

be viewed as analogous to the results that would be obtained if the investor engaged in a series of rolling futures or forward contracts, and simultaneously posted cash collateral with the financial institution (the forward seller), on which the financial institution (the forward seller) paid interest.

Other ETNs track the performance of a notional investment in a basket of cash securities that pay a current yield (for example, an ETN that tracks the “Dogs of the Dow” investment strategy). The current dividends or other yields on the underlying securities in turn notionally are reinvested in the basket, so that relevant ETN index constitutes a “total return” index. The constituent securities in the index in turn are periodically “rebalanced” in accordance with the predetermined rules of the synthetic investment strategy. Consistent with the prior discussion, the economic position of the investor in such an ETN can be viewed as similar to that of an investor who pursued the underlying investment strategy by buying the actual “cash” securities that comprise the index.

Tax Rules Related to Forward Contracts and ETNs

Forward contracts generally

The execution of a forward contract generally has no immediate income tax consequences even though the economic risks and rewards relating to the property underlying the contract shift at the time of the contract’s execution. In general, as an executory contract, a standard forward contract is treated as an open transaction until the contract is settled.²

If a forward contract is settled by delivery of the property underlying the contract, the taxpayer delivering the property recognizes gain or loss based on the difference between the price received and the taxpayer’s basis in the property.³ The character of the gain or loss generally is the same as the character of the property delivered.

If a forward contract is settled by cash payment, the recipient of the payment recognizes gain and the payor recognizes loss at the time the payment is made. This gain or loss is capital if the underlying property is capital in nature.⁴

If a forward contract is sold, gain or loss is recognized, and the character of the gain or loss is capital if the forward contract is a capital asset in the hands of the selling taxpayer.

² The treatment of executory contracts as open transactions has been established in cases and administrative guidance. See, e.g., *Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930); Rev. Rul. 69-93, 1969-1 C.B. 139.

³ Sec. 1001. All section references are to the Internal Revenue Code of 1986 as amended (the “Code”).

⁴ Sec. 1234A.

The fact that a forward contract calls for payment by one party to the other party at the time the contract is executed has not been treated as changing the tax treatment of the contract.⁵

Special rules for forward contracts

Special rules may alter the normal tax treatment of forward contracts. For example, if a forward contract is part of a section 1256 contract because it is, for example, a regulated futures contract, the mark-to-market rules of section 1256 apply. Special rules apply to a forward contract that relates to foreign currency.⁶ If a taxpayer that enters into a forward contract is a dealer, the dealer mark-to-market rules apply.⁷ The timing and character of income and loss from a forward contract also may be affected by special rules for constructive sale transactions, short sales, straddles, hedging transactions, and conversion transactions.

ETNs

Existing ETNs generally are treated as debt for financial accounting purposes, and holders of these ETNs are subject to the credit risk of the issuing bank. Nonetheless, certain opinions of counsel provided to issuers of ETNs have concluded that these ETNs (other than ETNs that provide returns related to currency exchange rates) should be treated as prepaid contracts (and, by implication, that holders are not required to include in income any amounts during the time they hold the contracts, whether denominated as notional interest or otherwise).

In published guidance, the Internal Revenue Service (“IRS”) has concluded that a prepaid instrument that is issued for and redeemed in dollars and that provides returns determined by reference to the euro and to market interest rates is euro-denominated indebtedness of the issuer.⁸ In related guidance, the IRS has announced that it is considering, among other questions, whether the parties to prepaid forward contracts (including ETNs) that are not treated as indebtedness should be required to accrue income or expense during the term of the contract.⁹

Federal Income Tax Issues Raised by ETNs

ETNs and other variants on prepaid forward contracts, whether publicly or privately traded, raise two different but overlapping important federal income tax issues. First, the underlying “index” to an ETN or similar financial product typically includes an explicit time value of money (i.e., interest) component, or alternatively includes the current yield on specified “cash” securities (e.g., the dividends paid on a specified basket of stocks). Issuers of these

⁵ Cf. Rev. Rul. 2003-7, 2003-1 C.B. 363 (Feb. 3, 2003).

⁶ Sec. 988.

⁷ Sec. 475.

⁸ Rev. Rul. 2008-1, 2007 WL 4284872 (Dec. 7, 2007 (release date)).

⁹ Notice 2008-2, 2007 WL 4284763 (Dec. 7, 2007 (release date)).

instruments, however, maintain that investors need not reflect this current return in income. If correct, this tax result would be materially more favorable to investors than the result they could obtain through investments in traditional financial products, such as an instrument recognized as debt for tax purposes or an investment in a regulated investment company (i.e., a mutual fund).

Second, the underlying index that determines the ETN's financial payoff to an investor often is not static, but rather represents a series of notional investments and reinvestments in short-term futures contracts or a basket of securities the composition of which is periodically rebalanced. Again, an investor in the actual futures contracts or underlying securities (whether directly or through an investment vehicle like a regulated investment company) would recognize gain or loss as those futures contracts rolled or the securities portfolio was rebalanced.

These two fundamental problems in turn are exacerbated by the very long-term maturities of many ETNs—often, 30 years. If the tax analysis proposed by issuers of ETNs and similar instruments were to prevail, investors in such instruments would thus be able to defer tax from the current returns with which they are credited, and from the sales and purchases with which they are credited, for up to 30 years. At the same time, investors suffer no loss of liquidity, because issuers of ETNs (at least) offer investors the opportunity periodically to redeem their interests for the net asset value of the index constructed for that ETN.

Description of Bill

In general

The bill provides rules for the tax treatment of prepaid derivative contracts (as defined below). The bill generally requires the holder of a prepaid derivative contract to include as interest income each year in respect of the contract an amount determined by reference to a short-term interest rate. The holder's basis in the contract is increased by amounts included as interest. The amount of gain or loss on the disposition of the contract therefore is determined by taking into account prior income inclusions.

The amount of interest income required to be included in respect of a publicly traded prepaid derivative contract is capped in a manner that prevents the amount of this interest income from exceeding the amount of gain that accrues on the contract during the time the taxpayer holds the contract.

The bill does not affect the tax treatment of the issuer of a prepaid derivative contract. The bill also is not intended to create any inference as to whether the tax treatment of ETNs or similar financial instruments advocated by the issuers or promoters thereof is correct under current laws.

Interest accrual amount

The amount of interest income required to be included each year with respect to a prepaid derivative contract (subject to the limitation described below for publicly traded prepaid derivative contracts) is referred to as the interest accrual amount. The interest accrual amount with respect to a prepaid derivative contract for any taxable year generally equals the product of

the holder's adjusted basis in the contract at the beginning of the year and the monthly Federal short-term rate determined under section 1274(d) for the first month ending during that year.¹⁰

If a prepaid derivative contract credits a holder with notional amounts and the rate at which the notional amounts are credited is higher than the applicable Federal short-term rate determined under section 1274(d), the interest accrual amount is determined by using the rate at which notional interest is credited. Thus, for example, if the return on a prepaid contract reflects the return that would be derived from an unleveraged investment in futures contracts on physical commodities plus the interest that would be earned if cash collateral were invested in Treasury bills, and the interest rate on the Treasury bills is higher than the applicable Federal short-term rate, the interest accrual amount is determined by using the Treasury bill rate.

If a taxpayer acquires or disposes of a prepaid derivative contract during a taxable year, the taxpayer's interest accrual amount in that year is prorated to reflect the number of days during the year on which the taxpayer holds the contract. Similarly, if a taxpayer acquires a prepaid derivative contract during a taxable year, the interest accrual amount for that year is determined by using the taxpayer's basis in the contract at the time of acquisition.

A holder's basis in a prepaid derivative contract is increased by any interest accrual amount that the holder includes in gross income. Consequently, interest inclusions have the effect of reducing the amount of any gain or increasing the amount of any loss on the sale of a prepaid derivative contract.

The following example illustrates the operation of the interest accrual amount and basis adjustment rules in a simple case. Assume a holder, a calendar year taxpayer, purchases a publicly traded prepaid derivative contract on January 1 of year one for \$100. Assume further that the Federal short-term rate determined under section 1274(d) for January of that year is four percent. At the end of trading on December 31 of year one, the value of the prepaid derivative contract is \$105. The prepaid derivative contract does not credit holders with notional amounts and does not provide for any actual distributions. (The bill's treatment of actual distributions is described below.) For year one, the holder includes as interest income \$4 (which equals the holder's \$100 basis in the contract multiplied by the four-percent Federal short-term interest rate), and the holder's adjusted basis in the contract increases to \$104. If the holder sells the prepaid derivative contract at the end of trading on December 31, the holder will have \$1 of gain on the contract.¹¹

¹⁰ The Federal short-term rate used for any taxable year in determining an interest accrual amount with respect to a prepaid derivative contract thus may vary from year to year over the holding period of the contract.

¹¹ The \$1 of gain will be short-term capital gain if the contract is a capital asset in the hands of the holder.

Treatment of losses

If a holder has a loss from the disposition of a prepaid derivative contract, the loss is treated as an ordinary loss to the extent it does not exceed the amount by which the holder's basis in the contract has increased as a result of prior inclusions of interest accrual amounts.

For instance, assume the taxpayer in the example described above does not sell the contract on December 31 of year one but instead sells the contract on January 1 of year two for \$97. Assume for simplicity there is no interest accrual amount in year two. The taxpayer has a \$7 loss from the sale of the contract (\$104 adjusted basis less \$97 amount realized on sale), of which \$4 (the interest accrual amount in year one) is an ordinary loss and \$3 is a long-term capital loss.

Treatment of distributions

If a holder receives a distribution under a prepaid derivative contract, the distribution is not includible in the holder's gross income. Instead, the holder's adjusted basis in the contract is reduced by the amount of the distribution (but not below zero), and any excess of the distribution over the holder's adjusted basis (determined immediately before reduction for the distribution) is treated as gain from the sale of the contract.

In determining the amount of basis reduction and gain (if any) resulting from distributions during a taxable year, the holder's adjusted basis in a contract is determined after increasing the holder's basis by the interest accrual amount for that year.

As an example of the operation of these distribution rules, assume a taxpayer buys a prepaid derivative contract on January 1 of year one for \$50. Assume that the applicable Federal short-term rate is five percent and that at the end of year one the value of the prepaid derivative contract is \$60. The taxpayer receives a distribution of \$3 on June 30 of year one. The taxpayer's interest accrual amount in year one is \$2.50 (five percent of \$50). The taxpayer's adjusted basis in the contract at the beginning of year two is \$49.50 (\$50 initial basis plus \$2.50 interest inclusion amount minus \$3 distribution).

Limitation on interest accrual amount for publicly traded derivative contracts

The interest accrual amount includible in a holder's gross income for any publicly traded prepaid derivative contract for a taxable year may not exceed the fair market value of the contract at the end of the year plus any distributions received by the holder during the year under the contract and less the holder's adjusted basis in the contract at the end of the preceding taxable year. Any excess of the interest accrual amount over the amount determined by application of the limitation is carried forward to the next taxable year and increases the taxpayer's interest accrual amount in that year.

If a holder disposes of a publicly traded prepaid derivative contract during a taxable year, the interest accrual amount limitation for that year is determined by using the fair market value of the contract at the time of disposition. Similarly, if a holder acquires a publicly traded prepaid derivative contract during a taxable year, the interest accrual amount limitation for that year is determined by using the holder's initial basis in the contract.

If the limitation just described has the effect of reducing the amount of interest a holder otherwise would include in income in a taxable year with respect to a publicly traded prepaid derivative contract, when determining the interest accrual amount in a succeeding taxable year, the holder's adjusted basis in the contract at the beginning of that year is determined as if the limitation had not applied. This rule has the effect of making interest on a publicly traded prepaid derivative contract compound annually based solely on the initial acquisition price of the contract and the applicable interest rate for each year and without regard to the limitation on actual annual interest inclusions.

A publicly traded prepaid derivative contract is any prepaid derivative contract (as defined below) that is traded on or subject to the rules of a qualified board or exchange or with respect to which the issuer or any person acting on behalf of the issuer regularly makes available to the public (including customers or subscribers) bid or offer quotes and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others.

The following example illustrates the application of the special limitation, carry forward, and basis adjustment rules just described. Assume a holder who is a calendar year taxpayer buys a publicly traded prepaid derivative contract on January 1 of year one for \$100. Assume further that the Federal short-term rate determined under section 1274(d) for January of that year is four percent. The prepaid derivative contract does not credit holders with notional interest amounts and does not provide for any actual distributions. At the end year one, the value of the prepaid derivative contract is \$102. In the absence of a limitation, the holder would include as interest income \$4 (which equals the holder's \$100 basis in the contract multiplied by the four-percent Federal short-term interest rate), but because of the limitation, the holder includes as interest income \$2 (the contract's \$102 value at the end of the year less the holder's \$100 initial basis in the contract). The \$2 by which the interest accrual amount determined without the limitation exceeds the amount of interest included after application of the limitation is carried forward to year two.

Assume in year two the applicable Federal short-term rate remains four percent. Solely for purposes of determining the interest accrual amount in year two, the holder's adjusted basis at the beginning of the year is \$104. The interest accrual amount in year two is \$6.16 (\$4.16, which is the \$104 adjusted basis at the beginning of the year multiplied by the four-percent Federal short term rate, plus the \$2 carry forward from year one). At the end of year two, the value of the contract is \$115. The interest accrual amount limitation in year two is \$13 (the \$115 value of the contract at the end of year two less the holder's \$102 adjusted basis at end of the preceding taxable year). Because this limitation exceeds the \$6.16 interest accrual amount, the entire \$6.16 is included in income in year two.

Exceptions

The bill does not apply to any prepaid derivative contract for any taxable year if (1) the contract is held for less than one year and is disposed of in the taxable year in which it is acquired or on or before the due date for filing the income tax return for that year (without regard to any extensions) or (2) the taxpayer marks the contract to market for the taxable year under section 475, section 1256, or any other Code provision.

Anti-avoidance

The bill directs the Secretary to issue any regulations necessary to carry out the bill's purposes, including regulations to prevent avoidance of the purposes of the bill.

Prepaid derivative contract defined

Subject to certain exceptions described below, a prepaid derivative contract is any prepaid contract that has a term longer than one year from the date of issue and that is a derivative financial instrument with respect to any security (as defined in section 475(c)(2)), any commodity (as defined in section 475(e)(2)) (or any group of securities or group of commodities), or any financial index, except that the term does not include any prepaid contract that is a derivative with respect to a position described in section 475(c)(2)(F) or 475(e)(2)(D) (that is, in general, a position that is a hedge with respect to a security or commodity subject to section 475(c)(2) or 475(e)(2)).

The term prepaid derivative contract does not include any instrument that is treated for purposes of the Code as stock or debt; a partnership interest; part of a constructive ownership transaction to which section 1260 applies; a hedging transaction; a notional principal contract; or an option. Under an anti-abuse rule for options, to the extent the Secretary provides in regulations or other guidance, an option is not excluded from the definition of a prepaid derivative contract if as a result of the option's term and strike price, the holding of the option is economically similar to ownership of a prepaid contract. For example, under this rule the Secretary may provide guidance under which holding a deep-in-the-money option (determined by comparing the option's strike price to the forward price, rather than to the spot price, of the property to which the option relates) is subject to the rules of the bill.

A prepaid contract is any contract under which there is no substantial likelihood that the taxpayer will be required to pay any additional amount under the contract. If additional amounts have been set aside or are expected to be set aside for future payment under a prepaid contract or are subject to a defeasance arrangement or another arrangement similar to one described in section 470(d)(1)(B), a taxpayer will be treated as not having a substantial likelihood of being required to pay those additional amounts and therefore will be subject to the bill in respect of the prepaid contract (assuming the other requirements for treatment as a prepaid derivative contract are satisfied).

Effective Date

The bill applies to contracts acquired after the date of enactment.